Jemena Electricity Networks (Vic) Ltd

2016-20 Electricity Distribution Price Review
Regulatory Proposal

Attachment 9-3

Averaging period proposal

Confidential

30 April 2015

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GLOSSARY

JEN	Jemena Electricity Networks
EDPR	Electricity Distribution Price Review
Guideline	Rate of Return Guideline

1. PROPOSED AVERAGING PERIOD FOR ESTIMATING THE RISK-FREE RATE AND RETURN ON DEBT FOR THE FIRST YEAR

1.1 PROPOSED AVERAGING PERIOD

1. Jemena Electricity Networks (**JEN**) proposes to use the 15 business days from [[redacted]] to [[redacted]] (inclusive) (**the averaging period**) as the period to estimate:

   a) The annual return on debt observation for the first year of the 2016 electricity distribution price review (**EDPR**) period, and

   b) The risk-free rate used to estimate the return of equity for all years of that period.

2. The estimates of these parameters over the averaging period will replace the equivalent estimates included in chapter 9 that were calculated using the market data over a 'placeholder' averaging period (the 20 business days to 30 January 2015).

1.2 CONSISTENCY WITH THE RATE OF RETURN GUIDELINE

3. The proposed averaging period is consistent with guidance in the rate of return guideline (the **guideline**) because it:[1]

- Falls prior to the commencement of JEN's next regulatory control period
- Falls as close as practical to the start of the first year of this period (i.e. 1 January 2016)
- Occurs after the date of JEN's 2016 EDPR proposal (i.e. after 30 April 2015).

4. We also propose using the same averaging period for both the return on debt and return on equity, consistent with rule 6.5.2(e)(2):

   In determining the allowed rate of return, regard must be had to:

   …

   - *the desirability of using an approach that leads to the consistent application of any estimates of financial parameters that are relevant to the estimates of, and that are common to, the return on equity and the return on debt.*

5. Although consistent with the guidance in paragraph 3, the proposed averaging period for the return on equity does depart from the guideline because its length (15 business days) is not 20 business days. We consider this departure is necessary to satisfy rule 6.5.2(e)(2) and does not undermine the allowed rate of return objective.

[1] AER, *Better Regulation Rate of return guideline*, December 2013, pp. 21–22.

1.3 CONFIDENTIALITY

6. Consistent with the rate of return guideline and previous regulatory practice, we propose keeping the averaging period confidential until after it has passed. This gives JEN an opportunity to align its actual funding costs with the allowed rate of return estimated over this period without the risk of other market participants using this information against our legitimate commercial interests.

2. AVERAGING PERIODS TO BE USED FOR CALCULATING THE RETURN ON DEBT FOR LATER YEARS

2.1 IMPLEMENTING THE TRAILING AVERAGE APPROACH

7. As discussed in Attachment 9–2, JEN proposes applying a trailing average method to calculate the return on debt. Under this method, the return on debt is updated for each year of the next EDPR period, in accordance with a trailing average formula. The trailing average methodology proposed by JEN is consistent with the guideline,[2] although we propose departing on how to transition to that average (see Attachment 9–2).

8. In order for the trailing average formula to update throughout the next EDPR period, an annual return on debt observation is needed for each year. This requires averaging periods to be first nominated and then used to calculate the annual return on debt observation for each year.

9. Section 1 sets out the averaging period that JEN proposes for calculating the annual return on debt observation for the first year of the next EDPR period (i.e. the first averaging period).

2.2 PROCESS FOR NOMINATING FUTURE AVERAGING PERIODS

10. For each subsequent year of the next EDPR period, Attachment 9–2 sets out a process for nominating (and the AER approving) an averaging period for calculating the annual return on debt observation.

11. Once the averaging period is nominated and approved as per the process set out in Attachment 9–2, the process for calculating the annual return on debt observation is applied automatically and the trailing average return on debt formula is updated.

12. The process for nominating averaging periods set out in Attachment 9–2 provides that (among other things):

- The averaging period used for calculating the annual return on debt observation for each of the later years of the next EDPR period (i.e. all years other than the first year) must be nominated by JEN at least 50 business days prior to the start of the calendar year in which it is to occur, and

- The nominated averaging period must be a period of at least 10 consecutive business days, falling entirely within the calendar year immediately prior to the calendar year for which it is to be used to calculate the annual return on debt observation.

13. This process is a departure from the guideline.

2.3 NOMINATING THE SECOND AVERAGING PERIOD

14. This process implies that the averaging period used to calculate the annual return on debt observation for the second year of the next EDPR period (calendar year 2017) must fall entirely within the first year of the next EDPR period (calendar year 2016) and JEN must nominate this period at least 50 business days prior to the start of the first year (i.e. no later than 11 November 2015).

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2 AER, *Better Regulation: Rate of return guideline*, December 2013, pp. 19–20.

15. Our proposal is unlikely to be approved in time to allow for nominating and approving an averaging period for calculating the annual return on debt observation for the second year of the next EDPR period as per the process set out therein. However, JEN proposes following this process to nominate an averaging period to fall in calendar year 2016, even if the proposed AA is not approved in time for the start of this process.

16. As per the process set out in the proposed EDPR, JEN will nominate an averaging period to fall in calendar year 2016—for calculating the annual return on debt observation for the second year of the next EDPR period—no later than 11 November 2015. JEN intends to nominate at the same time as it provides its response to the AER's draft decision.

2.4 NOMINATING THE THIRD AND SUBSEQUENT AVERAGING PERIODS

17. JEN will nominate averaging periods to fall in calendar years 2017, 2018 and 2019, and subject to AER approval, as per the process set out in Attachment 9–2. JEN will use these averaging periods (once approved) to calculate the annual return on debt observations for calendar years 2018, 2019 and 2020 respectively—which we will in turn use to update the trailing average return on debt formula.

18. Attachment 9–2 further explains our proposed nomination process and our reasons for this.